

## GROWTH AND STABILITY (Theoretical framework, experience, the Croatian case)

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### INTRODUCTION

Economists have developed numerous theories for explaining complex economic phenomena and providing a basis for possible policy advice. The explanatory power of these theories has been empirically tested. In spite of their theoretical complexity by their nature these theories must involve simplifications of the reality they seek to explain. As a result they leave ample room for controversies while their empirical verification can lead to contradictory results because of the numerous constraints such test impose.

The purpose of the introductory paragraph is to warn the reader that a certain degree of skepticism is necessary and that he must not succumb to the illusion that extremely complex phenomena can be simply and easily explained in a way which leads to unambiguous policy recommendations. With this in mind he should consider the analysis which follows.

Growth and stability are certainly two phenomena which do not lack complexity. In spite of major advances in economic theory it remains unclear which factors contribute to growth and in which way they do so. Equally, it remains unclear what are the dominant requirements for achieving and maintaining stability and low inflation rates. While advances have been made in each of these fields (in standard growth theory endogenous growth theories have explicitly introduced human factor which together with institutional economics has somewhat diminished the "terra incognita" of growth analysis while rational expectations theories have made a seminal contribution to the rudimentary Keynesian tools for analyzing inflation and stabilization

policies) the link between growth and macroeconomic stability remains theoretically unclear and consequently empirically insufficiently tested. Together, these two features present serious limitations for any possible relevant economic policy conclusions.

All governments seeking to increase growth rates while maintaining stability as well as international financial organizations trying to achieve growth and stability in the world economy find themselves in this insufficiently clear theoretical and empirical area. This led to a conviction which was based more on empirical than theoretical grounds. It claimed that the necessary preconditions for stable sustainable growth are macroeconomic stability and an overall system of efficiently functioning markets. As a result, all levels of economic policy gave special attention to macroeconomic stabilization and restructuring policies which attempted to influence the key growth factors, i.e. savings, investment in physical and human capital, capital productivity and technological development.

The remainder of this paper, without seeking to provide an all encompassing analysis, will attempt to present some recent results of empirical research of the growth-stability nexus and then concentrate only on those aspects which seem especially relevant for Croatia. By using a simple analytical model the following links will be discussed: (i) domestic savings, foreign capital inflows and the real exchange rate, (ii) the above links together with macroeconomic policies, the internal and external equilibrium and growth in Croatia in recent years and finally (iii) the links between capital inflows, the exchange rate, internal and external equilibrium and stabilization policies in conditions of money substitution in Croatia.

The analysis will show that following Croatia's independence and war the changing relationship between domestic savings and investment on the one hand and imports and exports on the other resulted in changes in

the real equilibrium exchange rate. The analytical results are supplemented by national account estimates.

Furthermore the paper will show that after a credible reduction in inflation rates there was an inflow of capital. This foreign capital was largely a result of inverse money substitution, i.e. capital repatriation and depletion of "mattress" reserves. Until the second half of 1994 this inflow was driven by rising demand for money, this in turn influenced exchange rate appreciation but did not have repercussions for the current account. In the second part of 1994 and during 1995 the economy experienced increased consumption which resulted in a current account deficit and further pressures for currency appreciation.

The main economic policy implication of this analysis can be summed up in the claim that growth requires increasing net domestic savings. Such a change would allow investments to rise along with exchange rate depreciation and increased exports. Without this precondition and in the environment of continued currency substitution any attempt to depreciate the currency in real terms by forcing a nominal depreciation would result in economic policy losing its credibility with consequences being an increase in inflationary expectations, a rise of inflation and a decrease of economic activity with unsustainable balance of payments position with a new wave of capital flight.

## **GROWTH AND INFLATION: THE EXPERIENCE**

Most empirical work linking growth with macroeconomic and structural variables is based on partial theories and an ad hoc choice of explanatory variables which themselves are not soundly embedded in economic theory. Consequently the results vary and offer themselves to different interpretations. But as Kahn and Villanueva (1991) stress even using reduced forms of completely specified growth models could not completely avoid simultaneity problems. This is because some of the exogenous economic and political variables could be considered

endogenous and defined as government reactions to certain macroeconomic events which could include changes in the growth rate. The authors illustrated this claim in a survey of recent empirical results dealing with the effects of economic policy on growth. Of the ten macroeconomic variables included fiscal policy variables show the greatest variability and hence ambiguity. On the other hand, exports and real interest rates (which can be considered as partially reflecting inflationary influences in reverse) have an unambiguous positive influence on growth.

Furthermore, empirical results do not unambiguously support the widely held opinion that mild inflation and growth are positively correlated in the short term cyclical change and negatively correlated in the long term. Data from the fifties and sixties seem to support the claim of a positive short term relationship which led to the famed Phillips curve. Data from the seventies and eighties do not empirically support this claim but the modified Friedman-Phelps version of the Phillips curve according to which cyclical unemployment can fall below the natural rate only if realized inflation rates are higher than expected ones.

But it was left to the recent work of Bruno and Easterly (1994) to provide a more robust negative link of growth and inflation. While the negative link is unambiguous for high inflation rates it remains empirically ambiguous for low inflation rates. The article notes an even more important empirical result for Croatia. They found that a successful reduction of high inflation rates is followed with strong economic recovery within a six year period, i.e. if sufficient time is allowed for the completion of economic adjustment. The following scenario emerges from this result: after first falling and then negative growth rates caused by high inflation rates an inflationary crises emerges (the threshold of the inflationary crises has been estimated at 40% at annual level) which is followed by successful stabilization leading to recovering growth rates which are eventually higher than those from before the crises.

The study does not explain the mechanism on which this empirical process is based and most of the proof remains in the domain of the anecdotal. It was also noted that after the crises fiscal policy is much more conservative and that either an independent central bank emerges or the independence of an existing central bank increases. Furthermore, after stabilization the link between the budget and monetary policy was often broken or limited while increased trade liberalization led to increased productivity and competitiveness which in turn acted to prevent the return of inflation. Financial sector rehabilitation and recovery have also been noted as possible channels of growth recovery. The possible effects of a break down of interest groups and lobbies during the crises is also stressed as well as the positive effects this can have on the improved functioning of markets and growth recovery in the post-crises period. Another interesting result of the study is that investment recovery is, as a rule, slower than growth recovery. This in turn seems to support a recent hypothesis that investments follow growth and not vice versa.

A careful observer of Croatia cannot omit noticing that all the cited economic policy changes enabling growth recovery after successful price stabilization are present in Croatia. Thus some important but not, as will be later shown, all the preconditions are present. Hence it is up to credible and prudent economic policy to use the opportunity provided. But as the authors of the cited paper note in their conclusion this is only partially a matter of expertise but of political economy to explain why in spite of the clearly determined favorable effects on growth stabilization policies are frequently postponed.

## **THE CASE OF CROATIA**

This section discusses the link between macroeconomic equilibrium and growth in the Croatian context. Dynamic macroeconomic equilibrium is defined as a state in which growth is consistent with low and stable inflation rates and a sustainable balance of payments. This definition is

derived from the hypothesis that while growth is perhaps linked to high inflation and balance of payments deficit in the short run in the medium and long term high inflation and rising foreign indebtedness are negatively linked to growth.

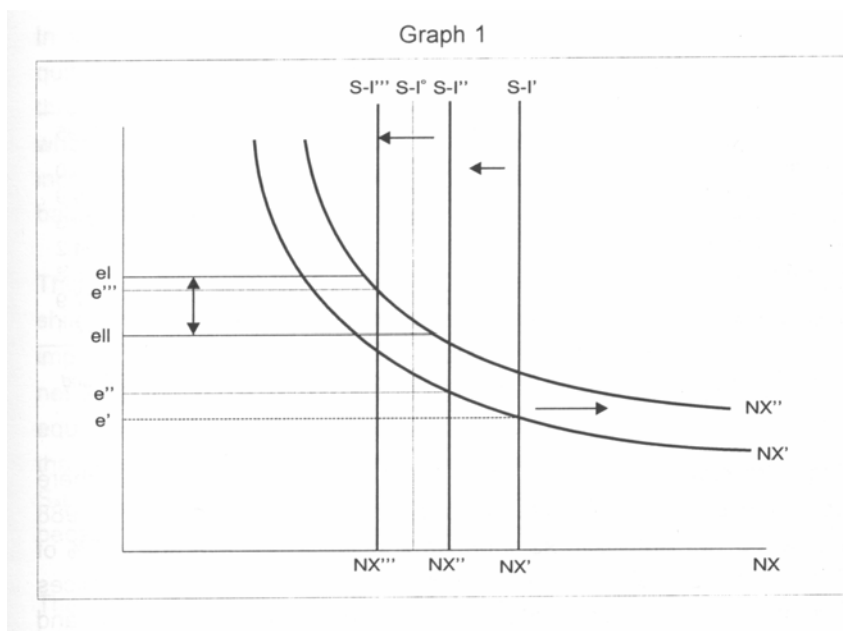
In absence of a general growth model which would integrate growth and macroeconomic equilibrium the paper's analysis of macroeconomic equilibrium will rely on the model of a small open economy with growth introduced in informal terms. Special attention will be given to savings, investments, balance of payments and the real exchange rate, variables which according to growth theory are the main determinants of long term growth.

This framework will be used to analyze why after independence and war Croatia experienced real exchange rate appreciation and what economic policy can and should do to enable growth in a stable economic environment, i.e. growth with internal and external equilibrium. It should be noted, however, that external equilibrium does not imply a balanced balance of payments but sustainable and consistent to the current phase of development.

The approach can be depicted in a graph with curves showing internal and external equilibrium. The intersection of the curves determines the equilibrium real exchange rate. An informal analysis will, however, be used to determine whether this exchange rate is consistent with dynamic equilibrium, i.e. whether it supports sustainable growth.

The horizontal axes shows net exports (representing of the state of the current account balance) and vertical one the real exchange rate. The curve is negatively sloped because a lower real exchange rate implies higher net exports. Since savings are not functionally related to the exchange rate the S-I curve depicting net savings is shown as a vertical line (i.e. a line parallel to the axes showing the exchange rate). As a

consequence the real exchange rate is determined by the relationship of internal and external equilibrium.



Which events in Croatia after 1992 influenced shifts in the curves depicting internal and external equilibrium? If we assume that till 1992 the real exchange rate equilibrium was at  $e'$  where the  $NX'$  (net exports) and  $S-I'$  (net domestic savings) curves intersect then the economy was facing positive net exports, i.e. a surplus in the current account which equaled the surplus of domestic savings over investments. Data provided in the table indicate that such circumstances did in fact prevail. The dotted  $S-I$  is drawn to describe circumstances in which  $NX=S-I=0$  (it must be noted that the balance of payments surplus till 1992, more precisely till 1990 because until that year reliable data exists, includes the surplus resulting from the exchange with other parts of former Yugoslavia).

Table 1  
CROATIA'S NATIONAL INCOME ACCOUNTS  
structure in %

	av.1986-88	av.1989-90	1994	1995
1.GDP	100.0	100.0	100.0	100.0
2.Personal consum.	50.7	56.8	59.0	65.9
3.Public consum.	22.3	27.1	27.4	28.3
4.Total consum.	73.0	83.9	86.4	94.2
5.Savings (1-4)	27.0	16.1	13.6	5.8
6.Investments	20.3	15.7	15.0	17.9
7.Net exports = Net savings (5-6)	6.7	0.4	-1.4	-12.1

*Source: Društveni računi Hrvatske (Croatia's social accounts) 1986-1988, 1989-1990 and author's estimates*

The data clearly show that up to 1992 (more precisely 1990) there were two substantially different subperiods. During the 1986-1988 subperiod net domestic savings were positive, on average 6.7% of GDP, and their value equalled the net exports of goods and services (Because of difficulties distinguishing the populations current and capital transaction factor incomes and transfers are treated as capital account transactions. As a result savings are domestic savings and not national savings while net exports equal the so called resource balance and not current balance.) Due to falling production and high inflation rates during 1989 and 1990 there was a significant decrease of savings and a somewhat smaller decrease of investments. As a result net savings and net export fell to only about 0.4% of GDP. This is shown on the graph by the leftward shift of the I-S curve which in turn increased the real equilibrium rate from  $e'$  to  $e''$ .

From 1992 onwards, more precisely from the second half of 1991, the loss of the Yugoslav market and war caused a fall of production, savings and investment. War related risks had a negative influence on exports which was partially neutralized by trade redirection from the former Yugoslav market. Imports fell due to decreasing production and investments.



In addition to the above, with independence Croatia found itself in quite different structural circumstances. In former Yugoslavia Croatia through its current account surplus provided foreign currency for the whole economy. As a result with independence there was a major increase in the real exchange rate value which kept the external balance in equilibrium.

This, together with falling imports caused by economic contraction, shifted the external equilibrium curve to the right. The rightward shift implies that under the new circumstances with unchanged domestic net savings only a higher exchange rate could maintain the existing equilibrium of imports and exports. Since savings contracted faster than investments net domestic savings became negative shifting the S-I curve to the left and beyond the  $S-I=NX=0$ , i.e. net exports also became negative and equaled between 1 and 1.5% of GDP.

The new equilibrium exchange rate  $e'''$  is determined by the intersection of the  $NX''$  and  $S-I'''$  curves and it is significantly higher than the  $e'$  equilibrium exchange rate which prevailed during the eighties. Such circumstances lasted till the end of 1994. The remainder of the section will discuss the changes which occurred in 1995. Before addressing this issue it is necessary to answer the question whether the exchange rate prevailing in 1994 was a long run dynamic equilibrium exchange rate?

The long term equilibrium exchange rate is defined as that exchange rate which, given its long term determinants, results in simultaneous achievement of external and internal equilibrium in dynamic context. The answer to the posed question depends on whether the current exchange rate satisfies the definition.

In other words it depends whether the current exchange rate maintains low and stable inflation rates with unemployment close to its natural level, whether it is appropriate for the current phase of the cycle in such a way that the present discounted value of current and future surpluses

and deficits is zero and, finally, whether it maintains such a growth rate which maximizes per capita income in the long term.

It must be immediately noted that without a precise model linking the relevant variables a precise answer is not possible. What can be done is to analyze which of the key factors are not in accord with a dynamic long term equilibrium.

The analysis will disregard some important factors which influence the equilibrium exchange rate, e.g. the terms of trade, technology, capital flows, productivity changes and the efficient functioning of markets. This will be done because these factors are to a large extent exogenous and difficult to observe or measure and to keep the analyses manageable. The analyses will thus concentrate on the fundamentals which are observable and/or constitute economic political variables or are under their direct influence. The variables in question are: savings, investment, public consumption, protection levels and exports. These variables are fundamental both for determining macroeconomic equilibrium and growth.

Which set of values of the variables are suitable for a small market economy maximizing living standards in the long run? Growth theory tells us that savings and investment into physical and human capital must be as large as possible, that the level of protection must be as low as possible and that public consumption must be as small as possible so as not to crowd out investments and exports and that exports must grow dynamically.

Furthermore, to satisfy the intertemporal balance of payments constraint the growth phase exhibiting an increased debt and foreign direct investment must be followed by a growth phase with a current account surplus which will enable unhindered debt servicing. With this in mind the growth rate must be at least equal to the world market real interest rate (i.e. in the medium term at least 5-6% and converging to a long

term growth rate of 2-3% which equals world market long term interest rates).

What were the values of variables in Croatia during 1994 when compared to their values in economies of similar size and level of development? In relation to pre-war levels the rate of savings has been halved to 13-14% of GDP. The share of gross fixed investments is a little larger, around 15% of GDP. This makes net savings negative. This in turn leads to a negative external balance equaling around 1 % of GDP. Obviously, increasing growth rates in the medium term requires a significant increase of the share of investments to 20-25% of GDP. Given the need to maintain external equilibrium within sustainable limits this implies the need for a significant increase of domestic savings. In other words, during the period in which it is increasing the external deficit on average should not in the medium term exceed 5% of GDP. Possible larger shares could be acceptable only on account of direct investments.

Identities (1) and (2) represent equilibrium conditions for the real sector of an open economy. From these it follows that increasing public consumption directly reduces savings and that a public sector deficit reduces savings further. The latter is clearly visible from equation (3) which is an expansion of equation (2).

$$(1) (Y-C-G)-I=NX$$

$$(2) S-I=NX$$

$$(3) (S_p-I_p)+(S_g-I_g)=NX$$

$Y$  = GDP,  $C$  = personal consumption,  $G$  = public consumption,  $I$ =investments,  $NX$ =net exports or balance of goods and non-factor services,  $p$  and  $g$  refer to private and public sector

Given the need to increase domestic savings the 28% share of public consumption in GDP is too large. An alleviating condition is found in the fact that public sector was balanced during 1994 and so did not further

reduce savings through a deficit. It follows that public consumption should be decreased and that creating a deficit should be avoided. Perhaps even a small surplus should be created, this would make room for a larger increase in private investment without excessively increasing the external deficit.

Furthermore and along with the endogenous growth theory the share of expenditures for education, health, science and technology, as investments in human capital, should be increased at the expense of defense expenditures. Empirical research, see Knight, Loazya and Villuaneva (1995), show the latter to have a clear negative impact on long term growth.

A further liberalization of the trade regime, i.e. lowering protection and opening up to the world economy, provide further stimuli to export growth by influence on equilibrium exchange rate depreciation and all the known advantages which increasing international trade has for the growth and stability of a small economy.

The implementation of such a scenario leads to high and stable growth under one precondition: that low and stable inflation rates prevail.

How would the mentioned favorable changes be reflected in the real exchange rate and would the long term equilibrium real exchange rate which is consistent with the above scenario be different from the current one? The graph provides a framework for analyzing the influence of the favorable changes.

The influence a further liberalization of the foreign trade regime would shift the NX curve further to the left. This would, *ceteris paribus*, lead to a depreciation of the real exchange rate and thus provide an incentive for increasing exports.

Whether the S-I curve will shift and by how much depends on changes in savings and investment during the phases of the growth cycle. If economic policy would reduce the share of consumption in GDP the consequent rise of savings would shift the curve right and lead to a depreciation of the real exchange rate. But with the rise of investments the final outcome would depend on the relative dynamics of the two. The assumption that during the first phase the share of investments in GDP would rise faster than the share of savings would lead to a rising negative share of net saving, albeit at higher absolute levels, which would shift the S-I curve left and lead to an appreciation of the exchange rate. In later stages and for higher income levels the share of savings would increase, this would gradually shift the I-S curve right. The S-I curve could approach the dotted S-I curve from either side, depending on the relationship of the other mentioned factors and on those whose influence has been omitted in the analysis.

The described shifts of the curves would result with the equilibrium exchange rate moving in the range defined by  $e_l$  and  $e_{ll}$ . During the first phase it would move in the direction of  $e_l$  and during the second in the direction of  $e_{ll}$ . It is clear then that there is no fixed long term equilibrium exchange rate, see Edwards (1988), and that the current one is located on the path on which the long term equilibrium exchange rate is located.

The analysis, however, points out another thing: the current real exchange rate is determined by values of fundamentals which are not in line with high long term growth rates. However it must also be noted that the exchange rate is an endogenous variable. Thus efforts to change nominal rates without changing the fundamentals would only result in macroeconomic disequilibrium and a negative influence on determinants of long term economic growth. The same is true of interest rates because the exchange rate and the interest rate are more or less directly linked by their determinants.

The analysis leads to the conclusion that economic policy should concentrate on changing the variables along lines consistent with dynamic stable long term growth while at the same time maintaining low and stable inflation rates. Economic policy must thus rely on macroeconomic, structural and institutional building policies to provide a stable but flexible business environment which will enable the efficient implementation of policy incentives aimed at increasing savings, investments and strengthening competitiveness in order to achieve the maximum rate of integration into the world economy.

Describing the required policies and mechanisms, even providing their rough outline is outside the scope of this paper. It must, however, be stressed that in this process the role of the state is to provide a favorable environment for changes but that the leading role must be left to the markets, i.e. private entrepreneurs.

The final part of this paper will attempt to deal with economic developments during 1995. They will be described within the already introduced analytical framework which will be somewhat expanded. The expansion relates to the introduction of the capital account, the monetary sector together with its specifics, i.e. by introducing the influence of money substitution which is present in the Croatian economy. With this in mind equation (3) will be expanded as follows:

$$(4) (Sp+FI+Ip)+(Sg+Ig)=NX+FI=dNFA=dM-dDC$$

$$(5) NX=dNFA-FI$$

$$(6) dM=dMD+dFDA+dFC$$

$$(7) dNFA=dFAB+dFDA+dFC+dFLB+dFLP$$

FI=foreign direct investment, NFA=net foreign assets of the monetary and non monetary sector, M=broadly defined money, MD=domestic money including foreign exchange deposits in domestic banks, DC=domestic credits, FC=residents' holdings of foreign currency, FDA=residents' deposits in foreign banking sector, FLB=foreign liabilities

of monetary sector,  $FLP$ =foreign liabilities of non-monetary sector; other symbols were defined previously.

From equation (4) it follows that net domestic saving in the private and public sector equal the external balance (the sum of current and capital account balances) which equals change in net foreign assets which is in turn equal to changes in broadly defined money and credits. This shows the links between the real and monetary sector in an open economy.

The money substitution is reflected in equation (6). The equation shows that the quantity of money is defined both by domestic money ( $MD$ ) and foreign currency held in the country by the private sector ( $FC$ ) and deposits by residents held in foreign banks ( $FDA$ ). It is also reflected in a part of domestic money held by residents as foreign currency deposits in domestic banks. Due to this definition the net foreign assets must include both the assets of the domestic monetary system and assets and liabilities of the domestic non-monetary sector (i.e. citizens and firms).

Money substitution has numerous implications for economic policy and economic changes in the country. There is a voluminous literature on the subject. This paper will limit itself to use the described expansion of analytical framework in attempt to explain events in Croatia during 1995 with reference to the main topic discussed.

What did in fact happen? Following a successful reduction of inflation rates in late 1993 there was a change in relationship of the demand for domestic money and foreign currency in the non-banking sector. The change resulted from changes in the risk-adjusted rates of return on foreign and domestic assets. Consequently during remonetization of the economy there was inverse money substitution, i.e. part of foreign non-monetary sector assets were converted into domestic assets (this was primarily true for the part with transactions function, i.e. part of  $FC$ ).

The inflow of foreign capital (which had the form of a reduction of foreign currency in circulation, FC and depleting and converting deposits held in foreign banks, FDA) did not have a major impact on the current account. This is because the process of changing the structure of financial assets of the non-monetary sector took place during most of 1994 when there was an increase in the demand for money. So the reduction of these components was paralleled with an increase in foreign assets of the monetary sector, FAB. The central bank intervened to reduce the pressure this process has on currency appreciation, both nominal and real (the latter due to stable prices). The resulted growth of domestic money supply was accompanied by increased demand.

During the first half of 1994 net domestic savings did not significantly change when compared to 1993. The increase of savings was followed with increased investments and the real exchange rate did not change significantly. As a result the two curves used in the graph did not shift.

Substantial changes developed during the second half of 1994 and especially by the end of the year. At the time wages and tax revenue started increasing and as a consequence public and private consumption increased. The private sector financed its increased consumption partly by depleting foreign assets (i.e. by running down their foreign currency savings in foreign banks) and partly by taking loans abroad (with much lower interest rates than those prevailing in the country). Some of the foreign currency returned into the banking system which enabled banks to grant loans at high interest rates which made the business very profitable. It was in part possible because in the post-hyperinflationary period there usually is an extremely great demand for loans.

High consumption rates fueled by wages, public revenue and the increasing credits under conditions of saturated domestic money demand continued into 1995. As a result domestic savings continued falling substantially. With the continued rise of private sector investment this led to a drastic reduction of net savings. The reduction was



counterbalanced by a big increase of the deficit in the goods and services balance which directly neutralized the large capital inflow. This reduced the pressure on the central bank so that it could sterilize the monetary effects of its relatively small increase in foreign assets thus decreasing the effects of money multiplication. At the same time a significant part of the new foreign exchange deposits with domestic banks had to be re-deposited abroad. This requirement provided a major limit on the short term negative effects which the change of locational composition of private sector foreign assets had on the balance of payments and exchange rate.

Stated succinctly macroeconomic equilibrium is maintained in a way by which the increased domestic disequilibrium is closed by increasing the external disequilibrium. The latter is financed by a fall of net foreign assets of the non-monetary sector and, in spite of the small increase of foreign assets of the monetary sector, by a fall of the net foreign assets of the whole economy.

In terms of the graph the described changes can be depicted as a large leftward shift of the S-I curve and a consequent further rise of the real exchange rate. This, however, did not happen so one could conclude that the real exchange rate is undervalued. Events justify asking why during 1995 there was no major appreciation of the real exchange rate? A possible answer is an assumed leftward shift of the NX. This shift would have resulted from further imports liberalization, falling productivity or due to changes of other fundamentals which influence the supply and demand of foreign currency. Regarding such changes there is no information.

Another approach would redefine the question. Since foreign and domestic prices changed at similar rates the previous question can be restated by asking why nominal exchange rates did not change? It must be noted that short term macroeconomic policy measures influence the real rate via the nominal rate. Similar causality operates for other

transitory variables and market imperfections. They can all cause the nominal and thereby the real rate to depart from equilibrium values in the short term. Part of the answer is in that.

But perhaps part of the answer to the question could be that the problem does not in fact exist! Perhaps the real exchange rate did in fact appreciate in spite that nominal rate remaining more or less unchanged. Under such circumstances the only way the real rate can appreciate is if domestic prices increase faster than foreign ones. It has already been stated earlier that domestic and foreign prices changed at similar rates. This conclusion was based on comparing retail and producer prices. But are these the only relevant prices?

For the Croatian economy changes of the wage rate are also important. Its importance is a result of labor being the productive factor with the highest share in exports. In addition to wages calculations of the real exchange rate could also use data on relative prices of tradables and nontradables. If this is done for Croatian data then it becomes clear that wages in Croatia increased by significantly higher rates than in its main trading partners. Similar conclusions can be drawn from the different rates of changes in the prices of tradables and nontradables. Therefore if these prices are included the calculation would indicate that the real exchange rate appreciated, just as the model predicts they would.

This raises a very interesting further question: why wasn't the wage increase completely passed over into price increases? The answer to that question and its implications will be dealt with on some other occasion.

The present analysis of economic events in 1995 will continue by addressing the central theme of this paper, i.e. the relationship of stability and growth. In this context the issue of rising investments does not cause difficulties. This cannot be said of decreasing savings resulting from expanding private and, especially important, public consumption. Both rates of change were way above GDP growth. A major portion of

the private sector negative net saving rate is covered by debts incurred abroad. This in itself is not unfavorable because a large part of it ended up as investment. Furthermore the private sector is reacting with a sound sense of business because by incurring a foreign debt it is avoiding paying prohibitively high domestic interest rates. In this way it is maintaining its competitiveness and avoiding contributing either to high financial sector profits or to covering its losses. It prefers leaving that to the state. Part of the deficit financed by depleting foreign assets can in a subsequent period result with attempts to build them up. Such changes would result with reduced consumption, favorable changes in the external balance and hence a depreciation of the real exchange rate. These developments can be considered as normal intertemporal substitution of consumption through borrowing and lending.

The problem is in that part of the debt resulting from a public sector deficit. There are indications that the public sector is increasing its consumption partly on account of not paying the private sector for goods and services consumed. Therefore the public sector deficit represents the significant part of counter balance to the external deficit. The public sector is reducing net savings both by increasing relative share of its current consumption and through a rising deficit. This brings it into conflict with both the growth target and the stability target.

It is difficult to assume that the private sector will continue the forced and high risk financing of the public sector. Here major economic policy correction are necessary in order to prevent both investments and exports, through pressures on currency appreciation, being crowded out so endangering economic growth. These policies would circumvent the need for inflationary financing once the private sector financing of the deficit is exhausted. Reverting to inflationary financing would endanger stability and thereby even further endanger growth. With such constellation of fundamentals influencing the real exchange rate we leave it to those arguing in favor of a forced nominal depreciation of the exchange rate to imagine the results their policy advice would have on

the economy in which about half the domestic liquidity is in foreign exchange deposits and at least as much is in circulation and deposits in foreign banks. It is certain that such a forced depreciation would cause major losses in part of the private sector and that renewed inflationary expectations and inflation would lead the economy back to a state in which it was before the October 1993 stabilization program. In fact it would drive it even further back because it is much more difficult and expensive to regain lost credibility.

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